Office-Supreme Court, U.S.
FILED
JAN 20 1962
JOHN F. DAVIS, CLERK

No. 678

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1961

GENERAL GEOPHYSICAL COMPANY, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner, General Geophysical Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case (No. 18,530 below), reversing the findings of the United States District Court for the Southern District of Texas, Houston Division, in favor of petitioner.

## CITATION TO OPINIONS BELOW

The opinion of the District Court (R. 114-123), printed in Appendix A hereto, *infra*, p. 23, is reported in 179

F. Supp. 208. The District Court entered judgment for the plaintiff for the amount sued for (R. 124). The original opinion of the Court of Appeals (R. 235-244), printed in Appendix B, *infra*, p. 33, and its opinion in connection with overruling petitioner's petition for rehearing (R. 312-313), printed in Appendix C hereto, *infra*, p. 43, are not yet reported.

## JURISDICTION

The judgment of the Court of Appeals, reversing the findings of the District Court in favor of petitioner, was entered on October 20, 1961 (R. 235, *infra*, p. 33). On November 8, 1961, petitioner filed its petition for rehearing (R. 246-276), and its motion that its petition for rehearing be heard en banc (R. 277-314). Nine copies of that petition and that motion are filed with the Court herewith. The opinion and order of the Court of Appeals denying rehearing was entered on December 7, 1961 (R. 312-313, *infra*, p. 43). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254 (1).

## QUESTIONS PRESENTED

In order that the questions presented may be clearly and distinctly grasped, we believe a brief summary of the case is necessary.

Petitioner was and is a geophysical company engaged in oil exploration for oil companies. Its founder and mainstay, Earle W. Johnson, died suddenly in August, 1953, leaving a bank as his executor. His estate, widow and mother and a close friend owned 77% of the stock. The remaining officers, who owned very little stock, and the Bank, acting for itself and the others mentioned above,

arrived at a price of $1,225,245 for the retirement of their stock, petitioner having a surplus of over $1,738,944.36. Prior to consulting its counsel the Bank tentatively agreed to let petitioner retire the stock for $478,720 cash *and* $746,525 *notes* of petitioner. The Bank's counsel, as soon as consulted, advised the Bank that under the decision of this same Court of Appeals for the Fifth Circuit in *Robinson v. Wangemann*, 75 F. 2d 756, (1935),[1] if petitioner should become bankrupt, the Bank as holder of the notes would come behind all other creditors of petitioner, both present and future, and it in its fiduciary

[1] In Robinson v. Wangemann, 75 F. 2d 756, a case coming up to the Fifth Circuit Court of Appeals from Texas, a corporation retired a stockholder's stock with a note. At that time it had an ample surplus but, before the note was paid, it went into bankruptcy. The Fifth Circuit held that the noteholder came behind all creditors, those existing at the time the note was given or thereafter arising. The Court said in part:

"A transaction by which a corporation acquires its own stock from a stockholder for a sum of money is not really a sale. The corporation does not acquire anything of value equivalent to the depletion of its assets, if the stock is held in the treasury, as in this case. It is simply a method of distributing a proportion of the assets to the stockholder. The assets of a corporation are the common pledge of its creditors, and stockholders are not entitled to receive any part of them unless creditors are paid in full. When such a transaction is had, regardless of the good faith of the parties, it is essential to its validity that there be sufficient surplus to retire the stock without prejudice to creditors, **at the time payment is made out of assets.** In principle, the contract between Wangemann and the corporation was executory until the stock should be paid for in cash. **It is immaterial that the corporation was solvent and had sufficient surplus to make payment when the agreement was entered into. It is necessary to a recovery that the corporation should be solvent and have sufficient surplus to prevent injury to creditors when the payment is actually made.** This was an implied condition in the original note and the renewals accepted by Arthur Wangemann." (Emphasis added)

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capacity should not take that risk. The Bank's counsel further advised it that, if petitioner retired the stock by paying $478,720 in cash and transferring to the Bank and widow properties of a fair value of $746,525 with no agreement or commitment by the Bank and widow as to the properties, the stock would be validly retired, and, if the Bank and widow thereafter sold the properties to petitioner for $746,525 in notes, it would avoid the rule in the *Robinson* case and not come behind the other creditors. The Bank advised petitioner's officers that that was the only way the stock could be retired. Those officers, not understanding the bankruptcy matter as they were not attorneys, refused to follow that procedure, but, when the Bank finally told them "to take it or leave it", they agreed. Up to that point there had been no discussion as to what properties should be used as the Bank and its counsel knew nothing in detail of petitioner's properties. Consequently no income tax considerations entered into the Bank's ultimatum. Petitioner then retired the stock for $478,720 cash and the transfer to the Bank and widow of certain properties at an agreed value of $746,525 with no agreement or commitment on the Bank's part as to what it would do with the properties. The Bank and the widow thereafter sold the properties to petitioner for its notes aggregating $746,525, which notes were duly paid. Petitioner had kept back its laboratory and principal properties so that it could go on in business even if the Bank did not sell the properties back to it. However, the only properties that it could convey to the Bank were various trucks, shot-hole drilling rigs, and other depreciable property. Owing to the existence of the Korean War and the great scarcity of the types of property involved, the properties that were trans-

ferred to the Bank, although depreciated on the books of petitioner to $168,290.98, had a fair value of $746,525. At no time did the Government ever question the rates of depreciation taken by petitioner or question the fact that the properties had this fair value of $746,525.

At no time since their stock was retired has the Johnson Estate, the widow, Johnson's mother or his friend Davis owned any stock in petitioner, and therefore none of them ever had any interest in the income tax effects of these transactions on petitioner.

These transactions occurred early in 1954, and, when petitioner filed its income tax return for that year, it computed its depreciation on the basis of the cost of these properties to it of $746,525. The Government contended that its cost should be only the $168,290.98.

The District Court (R. 114-123), Appendix A, *infra* p. 23), found that the Bank and widow were actuated solely by the bankruptcy point involved in the *Robinson case, supra*, that the Bank as executor and the widow obtained title to the properties free and clear of any claim by petitioner, that the sale of the properties by them to petitioner for $746,525 was a separate and distinct transaction, and that it would not be justified in treating the transactions as if petitioner had merely given its $746,525 of notes in retirement of the stock. The District Court therefore held that the cost of the properties to petitioner was $746,525.

The Court of Appeals in its original opinion, while stating that it recognized the bona fides of the parties, nevertheless stated that the transaction

> "gives off an unmistakably hollow sound when it is tapped."

reversed the District Court, refused to recognize the transactions at all,[2] and held petitioner's cost was the lower $168,290.98.

Petitioner duly filed its Motion for Rehearing and Motion that its Motion for Rehearing be heard En Banc, copies of which are filed herewith. The Court of Appeals ignored the en banc motion but overruled the motion for rehearing. It is most important to note that it wrote a further opinion on the rehearing. (R. 312-313, Appendix C, *infra* p. 43). In it that Court said that the Bank and widow and appellee had a perfectly valid business purpose in having the properties passed out in retirement of the stock, that thereby the bankruptcy rule involved was avoided, that it did

> "not question the integrity of the parties or suggest that there was any flim-flam,"

but still stated that

> "for tax purposes"

it would not recognize the transactions, saying the case was analogous to *Helvering v. Clifford*, 309 U. S. 331.

This petition presents the following important questions:

1. The undisputed evidence showed that the plan of transferring these properties in retirement of the stock did not originate with appellee or its officers but was forced upon it by the Bank as executor and widow whose stock was being retired. The Court of Appeals having found that it was all bona fide and there was no "flim-flam", was that Court justified in refusing, if we may use its own

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[2] The Court relied upon **Gregory v. Helvering**, 293 U. S. 465; **Commissioner v. Court Holding Co.**, 324 U. S. 331; and **Helvering v. Clifford**, 309 U. S. 331.

italicized words "*for tax purposes*", to recognize that petitioner had completely parted with title to the properties and had then bought them for $746,525?

2. The Court of Appeals having held that the transfer vested title to the properties in the retiring stockholders and was effective in protecting those stockholders from the bankruptcy rule in the *Robinson* case, supra, was that Court authorized to refuse to give effect to that transaction "for tax purposes" and hold petitioner did not buy the properties for $746,525?

3. Where petitioner and its retiring stockholders entered into this transaction whereby their stock was retired with the properties with no thought of the income tax consequences, was the Court of Appeals authorized to ignore everything that was done simply because petitioner would get a larger deduction for income tax purposes than it otherwise would?

4. It having become well established that, where the owner of property sells it but reserves an option to repurchase, the sale is perfectly valid for income tax purposes,[8] was the Court of Appeals justified in refusing to recognize the transfer of these properties to the Bank as executor and the widow and their subsequent sale to petitioner by the Bank and widow when petitioner reserved no option to repurchase them and the Bank and widow were under no obligation to sell them to petitioner? We submit that the decision of the Court of Appeals is in direct conflict with the decisions of the Board of Tax Appeals and Tax Court cited in the footnote.

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[8] **Oscar F. C. Kunau, et al., Trustees v. C.I.R.**, 27 B.T.A. 509, acq. XIII-2 C.B. 11; **Frank & Seder Co. v. C.I.R.**, 13 B.T.A. 1, acq. VIII-1 C.B. 15; **Resthaven Memorial Cemetery v. C.I.R.**, 13 B.T.A. 683; **Desert Lawn Memorial Park, Inc. v. C. I. R.**, 19 T.C.M. 32; **Irving Fisher v. C.I.R.**, 30 B.T.A. 433; **J Harold Frantz v. C.I.R.**, C.C.H. Dec. 10,493-A (not reported in regular B.T.A. reports).

5. The District Court having held that the transfer of the properties in retirement of the stock and the later purchase by petitioner of the properties for $746,525 were entirely separate and distinct transactions and having held that petitioner's cost of the properties was $746,525, did the Court of Appeals in overruling those findings of the District Court go counter to the rule announced by this Supreme Court in *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U. S. 331, *United States v. Cumberland Public Service Co.*, 338 U. S. 451,[4] and other cases, that in these tax cases the findings of the trial courts must be accepted where supported by evidence? **The holding of the Court of Appeals below on this point is in direct conflict with that of the Court of Appeals for the Ninth Circuit in United States v. McNair Realty Company handed down on December 13, 1961,** reported at this time only in Commerce Clearing House, Federal Tax Reporter, 62-1 USTC 9158, discussed on pages 15-17 hereof. A copy of that opinion is set out in Appendix D hereto, *infra*, p. 45.

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[4] In **Court Holding Co.**, supra, this Court stated:

"There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. Dobson v. Commissioner, 320 U. S. 489; Commissioner v. Heininger, 320 U. S. 467; Commissioner v. Scottish American Investment Co., 323 U. S. 119. On the basis of these findings the Tax Court was justified in attributing the gain from the sale to respondent corporation. * * *

"* * * The decision of the Circuit Court of Appeals is reversed, and that of the Tax Court affirmed."

In **Cumberland Public Service Co.**, supra, this Court said in conclusion:

"It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here, as in the Court Holding Co. case we accept the ultimate findings of fact of the trial tribunal. Accordingly the judgment of the Court of Claims is affirmed."

6. Are the income tax liabilities of taxpayers to be computed on the basis of their transactions entered into in good faith for valid business reasons or is a court to be allowed to compute their tax liabilities by ignoring such of those transactions as the court may choose to ignore?

7. Is the usual argument of the Government of substance versus form to be allowed to prevail to the extent it has prevailed in this case with the result that bona fide business transactions are to be ignored for tax purposes?

8. Did the transfer of the properties in retirement of the stock and their subsequent sale to petitioner for its $746,525 of notes remove the notes from the effect of the bankruptcy rule announced in the *Robinson* case?

## STATUTE INVOLVED

The statutory provision involved is Section 1012 of the Internal Revenue Code of 1954, 26 U.S.C. 1958 ed. Sec. 1012:

> SEC. 1012. BASIS OF PROPERTY—COST.
> The basis of property shall be the cost of such property, except as otherwise provided * * *.

## STATEMENT

We believe the summary statement we have given above sets out the essential facts. We will point out only a few additional facts.

The petitioner was represented by an attorney Hrdlka and its officers Sappington, Hall and Grubb and the widow and Bank by its trust officer Henderson and the undersigned Bruce. Henderson and Hrdlka died before the trial, and the other four mentioned were the only witnesses, and their testimony was uncontradicted.

The fact that these properties in 1954 had such a high value in comparison to their depreciated cost was due to

the scarcity of the properties involved resulting from the Korean War and inflation. It was not due to an unreasonable high rate of depreciation. The Government at no time questioned these values or depreciation rates.

The District Court filed extended findings of fact and conclusions of law in favor of petitioner (R. 114-123, Appendix A, *infra*, p. 23) and entered judgment for petitioner for the amount sued for (R. 124).

The Court of Appeals reversed the District Court (Appendix B, *infra*, p. 33). Although *stating* that it recognized the bona fides of the parties and the importance of their avoiding the bankruptcy rule in the *Robinson* case, supra, it nevertheless stated that it

> "should guard against giving force to a purported transfer which gives off an unmistakably hollow sound when it is tapped"

and further

> "A new horizon of tax avoidance opportunities would be opened by allowing a stepped-up basis to result from the transaction here effected. Corporations would be enabled without difficulty to raise the basis of their assets whenever it fell below the market value by transferring the assets to shareholders by a dividend or stock redemption and then buying back the same assets for the cash that they otherwise would have distributed directly."

Then relying on *Gregory v. Helvering*, 293 U. S. 465, *Commissioner v. Court Holding Co.*, 324 U. S. 331 and *Helvering v. Clifford*, 309 U. S. 331, it said it would not for tax purposes recognize the transactions and reversed the District Court.

Petitioner filed a very straightforward motion for rehearing, and, because it felt the decision departed radically from several prior decisions of the same Court, it filed a

motion for the rehearing to be heard en banc. We have filed with this Supreme Court copies of both motions and the briefs accompanying them. In our brief attached to the motion for rehearing we have on pages 1 to 14 thereof set forth the material facts and we invite this Court's attention to our discussion on those pages.

In the light of that motion for rehearing and possibly the motion en banc the Court of Appeals wrote a further opinion (Appendix C, *infra*, p. 43). It went to great pains to say that it did not question the good faith or integrity of the parties or suggest there was any "flim-flam" or doubt the business purposes of the transaction or question the effectiveness of the transaction in protecting the stockholders against the holding in the *Robinson* case, supra. Nevertheless, it held that *for tax purposes* (the Court italicizing those words), the case was analogous to *Helvering v. Clifford*, 309 U. S. 331 and therefore it overruled the motion for rehearing.

Apparently in accordance with its practice that Court took no action on the motion en banc.

## REASONS FOR GRANTING THE WRIT

1. The Court of Appeals in the direct face of many decisions of this Supreme Court and that Court itself and many other courts has decided this case on the flat proposition that, because petitioner's income taxes would be reduced by its having a higher deduction for depreciation, it would not recognize *for tax purposes* the transactions involved even though they were bona fide and actuated by sound business purposes. It said that it was controlled by *Gregory v. Helvering*, 293 U. S. 465, *Commissioner v. Court Holding Co.*, 324 U. S. 331, and *Helvering v. Clifford*, 309 U. S. 331. Those cases not only do not support the Court of Appeals but they directly support the

decision of the District Court. *Gregory v. Helvering* revealed a pure sham which this Court refused to recognize. (In a footnote are given typical quotations from other decisions of this Court pointing out the basis of the *Gregory* decision and showing its inapplicability to this case, emphasis being added.) In *Court Holding Co.* this Court said it was simply sustaining the findings of the Tax Court, while

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"In these circumstances the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." Gregory v. Helvering, 293 U.S. 465, 470.

"Gregory v. Helvering, 293 U.S. 465, **revealed a sham**—a mere device intended to obscure the character of the transaction. We, of course, disregarded the mask and dealt with realities. The present record discloses no such situation; nothing suggests other than a bona fide business move." Helvering v. Minnesota Tea Co., 296 U.S. 378, 385.

"Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts, where they add nothing of substance to the completed affair. Gregory v. Helvering, 293 U.S. 465; Helvering v. Bashford, 302 U.S. 454; Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184-185.

"In general, in matters relating to the revenue, the corporate form may be disregarded where it is **a sham or unreal**. In such situations the form is a bald and mischievous fiction. Higgins v. Smith, 308 U.S. 473, 477-478; Gregory v. Helvering, 293 U.S. 465." Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438.

"There is not present in either situation the **wholly useless temporary compliance** with statutory literalness which this Court condemned as futile, as a matter of law, in Gregory v. Helvering, 293 U.S. 465." John Kelley v. Commissioner, 326 U.S. 521, 525.

"Substantially all of the evidentiary facts were stipulated in both cases. Nor is there any finding in either case that the arrangements were a **sham**. Cf. Gregory v. Helvering, 293 U.S. 465." John Kelley v. Commissioner, 326 U.S. 521, 532. Justice Rutledge opinion.

"Of course even a corporation which satisfies the usual tests of agency may be disregarded by the Commissioner if it is **a sham or unreal**. Higgins v. Smith, 308 U.S. 473 (1940); Gregory v. Helvering, 293 U.S. 465 (1935). Escaping taxation is not a 'business' activity. See National Investors Corp. v. Hoey, 144 F. 2d 466; National Carbide Corporation v. Commissioner, 336 U.S. 422, 437.

in this case the Court of Appeals reversed the findings of the District Court. In *Clifford* a husband transferred some stocks to himself as trustee for his wife for only five years with the stocks then reverting to him. This Court properly struck the trust down as a subterfuge and held the trust income taxable to the husband. Petitioner has not gone even as far as this Court in the *Gregory* and other cases has said it could go to reduce its taxes.* It transferred the properties to the Bank and widow not to reduce its taxes but to avoid the rule in bankruptcy involved.

The Court of Appeals for the Fifth Circuit itself has in many cases announced the rule, directly contrary to that announced by its panel in this case, that it will recognize and give effect to bona fide business transactions even though they may result in less taxes being collected by the Government.

We ask if this same rule in this case would apply if the fair value at the transfer to the Bank and widow had been less than the depreciated cost to petitioner? For example, their depreciated cost was about $169,000. Suppose their fair value was only $100,000 and petitioner bought the properties back for $100,000. We venture to say that the Government would take exactly the opposite position and claim petitioner's cost thereafter was only $100,000. Should the rule be one way in our case and the other way in that case?

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* "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether avoid them by means which the law permits cannot be doubted." Gregory v. Helvering 293 U. S. 465, 469

C. I. R. v. Falcon Co., 127 F. 2d 277; Sun Properties, Inc. v. U. S., 220 F. 2d 171; Montgomery v. C. I. R., 230 F. 2d 173; C. I. R. v. Webster's Estate, 131 F. 2d 426. See also one of the closest cases on the facts, Henrickson v. Brucks, 137 F. 2d 632 (9th C. C. A.) where there was only a very brief interval in which stockholders held distributed properties and the transactions were sustained

On page 10 hereof we quote the lower Court's statement that this case would open up a new horizon for tax avoidance. In the first place we say that the courts should strike down as a sham any such examples as that Court referred to. In addition this was a very abnormal case of properties going to such excessive heights in value over their depreciated cost. If this transaction had occurred in 1959 when the case was tried, those high values would not have existed. For example, Grubb testified (R. 66-67) that one rig had been bought in 1947, had been depreciated to $10,000 in February, 1954, but, because new rigs could not be obtained, was worth then $125,000. But by 1959 conditions were reversed.* Grubb testified that one rig was bought in 1940 for $16,000 and was sold in 1955 for $25,000 but in 1959 it could not be given away (R. 71).

In a long practice beginning with the Revenue Act of 1918 this is the first case that we have seen where a court flatly stated that, regardless of the bona fides of a transaction, regardless of the perfectly adequate business reasons actuating a transaction, regardless of the fact that a transaction would have been handled in a certain manner whether there had been any income tax law or not, it would nevertheless not recognize such a transaction *for tax purposes* on the frank ground that it would reduce the income taxes to be collected by the Government. We believe that when the 16th Amendment to the Constitution authorized Congress to levy income taxes upon income,

* It is common knowledge that the oil business in the United States declined tremendously from 1954 to 1959. For example, Grubb testified that in 1954 petitioner had 30 geophysical crews in the field but in 1959 they were down to 14 crews (R. 75). It is also common knowledge as to the restrictions placed upon production of oil in Texas by the Texas Railroad Commission. According to its public records, for example, in October, 1952, it allowed wells in Texas to produce for 23 days, in December, 1955, for 17 days and in July, 1959, when the case was tried, only 9 days.

it was meant that the taxable income should be computed on the basis of transactions entered into in good faith for valid business reasons and not upon income computed by a court through ignoring such transactions, as was done in this case. We believe that it is extremely important that this rule be denied by this Court.

2. The holding of the court below in reversing the judgment of the District Court went directly counter to Rule 52(a) of the Federal Rules of Civil Procedure[9] and the specific statements and holdings by this Court in *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U. S. 331, and *United States v. Cumberland Public Service Co.*, 338 U. S. 451, to the effect that it is for the trial court upon consideration of an entire transaction to determine the factual category in which a particular transaction belongs.[10] The District Court (R. 122-123) specifically found that the transactions took the form they did because of the bankruptcy question, that the two transactions in which the stock was retired and the properties sold to petitioner were entirely separate and distinct, and that it was not justified in disregarding them. The Court of Appeals expressly refused to recognize those transactions in the face of Rule 52(a) and the opinions of this Court referred to above.

On this same point and on facts ninety percent similar to those in this case its holding is in direct conflict with that of the Ninth Circuit in *United States v. McNair Realty Company*, decided December 13, 1961.[10a] In that

[9] Rule 52(a): "* * * Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."

[10] See the quotations from those two cases set out in Footnote 1 to this petition.

[10a] Reported in Commerce Clearing House Federal Tax Reporter, 62-1 USTC 9158, affirming the District Court in **McNair Realty Co. v. U. S.**, 188 F. Sup. 451.

case the McNair Realty Company was owned by three McNairs, Ben and a brother and a sister. Ben and the brother also owned a partnership. Ben was in bad health and wanted to sell out his interest in the company. On June 26, 1952, the partnership, subject to the company's approval, agreed to a sale of one of the company's buildings. On September 2, 1952, the directors voted to retire Ben's stock by conveying to him a 63.556% interest in the building. On September 17, 1952, the directors authorized the sale of the building. On September 25, 1952, the company conveyed the 63.556% to Ben. This deed was recorded at 9:20 A. M. At 9:26 A. M. there was recorded a deed from the company and Ben to the purchaser. The Government sought to tax the company with the whole profit as if the sale had been made in its entirety by the company. The District Court held that there was a genuine liquidation of Ben's stock and he and not the company sold the 63.556% interest. The Ninth Circuit in a per curiam opinion (Appendix D hereto, *infra*, p. 45); affirmed the District Court on the rule announced by this Court in the *Cumberland* and *Court Holding* cases and in direct conflict with the Court of Appeals in this case, namely, that the findings of the trial court should control.

The two cases are further in direct conflict on the fundamental law of the case. In both cases there was first a retirement of a stockholder's stock with property. In each case there was an immediate sale of that property, in the *McNair* case to a purchaser who had already put up $25,000 earnest money on a contract of purchase, in this case by the Bank and widow back to the company. In the *McNair* case the distribution of the property to the stockholder was recognized *for tax purposes*, in this case

it was rejected *for tax purposes*. The two cases are in irreconcilable conflict.

The extreme importance of that rule that the findings of the trial court are not to be set aside unless clearly erroneous and the rule announced by this Court in the two cases cited above becomes clearer and more self-evident when the progress of a case is considered. To the trial court a case is a flesh and blood proceeding. The trial judge sees the witnesses and their reactions and hears directly all of the oral testimony and sees the written exhibits as they are introduced. He hears and considers the arguments and remarks of counsel during the progress of the case and then immediately after the close of the case and while the evidence is still fresh in his mind, he hears and considers the detailed presentation of the case by the attorneys of both sides. When a case is taken to an appellate court, that court sees only a cold printed record. Counsel for each side are allowed to make a very brief argument and no case can actually be adequately explained in a 15 or 30 minute argument. The appellate court cannot from a mere perusal of such a record and in the light of such a brief presentation get the feel of a case and of the facts as they are unfolded before the trial judge. It is important that this departure by the lower court in this case from this rule 52(a) and the specific directions of this Court referred to above should not be allowed to stand.

3. One of the most important reasons for this Court hearing this case and reversing the judgment of the Court of Appeals is the increasing prevalence on the part of the Government and particularly of the revenue agents, members of the Appellate Division of the Internal Revenue Service and other representatives of that Service and of the Government attorneys in using the argument of "substance versus form" to twist all transactions into the most

favorable light for the Government and against the taxpayer. To those of us handling matters with revenue agents, the Appellate Division and other representatives of that Service this argument of "substance versus form" is thrown in our faces in practically every instance where a taxpayer's income tax return is examined. It is constantly resorted to even by the Government attorneys in the trial courts and appellate courts. Regardless of how bona fide and for what valid business purposes a transaction may take a certain form, if another method of handling the deal would bring more taxes, the representatives of the Government raise the argument of "substance versus form". For example, in the Government's brief in the Court of Appeals in this case it is stated on page 16:

> "The controlling issue of whether the conveyance and re-conveyance of title to the assets should be recognized for income tax purposes requires application to the facts of this case of the established principle that *the substance rather than the form of a transaction is determinative of its tax effect.*" (Emphasis added).[11]

Even the Fifth Circuit Court of Appeals in decisions by other panels have rejected this automatic argument of "substance versus form".[12] If this present decision is

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11 Another example typical of this mesmeric argument that the Government makes is the statements in their brief in United States v. M. O. J. Corporation, 274 F. 2d 713 (5 C.C.A., 1960):

"Giving effect to the salutary rule that the **substance** of a transaction, **rather than its form, governs** its tax consequences the courts have generally held that when a purchase of the asset was intended and a liquidation was planned in order to acquire the asset the transaction will be viewed as a whole and considered for tax purposes as a purchase of the asset." (Emphasis added).

12 See cases cited in Footnote 7, supra.

allowed to stand, namely, that even though transactions may be taken with the utmost good faith and for the most impelling business purposes, nevertheless, they will not be recognized *for tax purposes* if they would reduce a taxpayer's income tax liability, it will aggravate and support more than any other decision this so prevalent "substance versus form" argument advanced by the representatives of the Treasury Department, with the result that more and more cases that should be disposed of without litigation will have to be brought before the courts.

4. Another reason why this case should be reversed is of less importance than the foregoing reasons. However, it is important that it should be reversed in aid of the administration of the income tax laws. We have pointed out on page 7 hereof in the fourth question presented and in Footnote 3, the long established decisions of the Tax Court that sales are perfectly valid for income tax purposes even though the seller reserves an option to repurchase. In this case the petitioner by duly executed deed and transfers of automotive certificates of title transferred the properties involved to the Bank as executor and the widow. Under the law of Texas and all other common law states this passed title to the transferees even though petitioner retained possession of the properties.[13] In this case petitioner reserved no option to

[13] We quote from 37A Texas Jurisprudence, Sales, § 9 as follows:

"§ 9.—Retention of Possession or Title by Seller.—Between the immediate parties to the transaction, a sale is not invalidated by the fact that the seller continues in possession of the property sold, or by the fact that he delivers the property into the possession of the buyer but retains title thereto. On the contrary, it is recognized that a buyer has the same right to leave the property purchased in the possession of the seller that he would have to take it into his own possession or to place it in that of a third person. And the fact the property remains in the possession of the seller does not prevent the passage of title."

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repurchase, the witnesses all testified that neither the Bank nor the widow had any obligation or commitment to sell the properties to the petitioner and the District Court found that the Bank and widow obtained the title free and clear of any claim on the part of petitioner. Yet the Court of Appeals has refused to recognize that transfer of those properties and then the sale of them to petitioner. The Government has always acceded to the decisions of the Tax Court holding that sales were valid even when there was a repurchase option as shown by their never appealing those cases. This case now obviously throws a cloud of doubt as to the correctness of those repurchase option cases and is in direct conflict with those repurchase option cases, and this Court should pass upon that question in the tax laws.

5. This Court may disagree with us, but we do raise the point that there is involved an important question in the administration of the bankruptcy laws. In the *Robinson* case the Court pointed out that, if stock is retired by a company and it has a surplus at the time the stock is paid for, then the stockholder is free and clear of all claims of creditors. That case recognizes necessarily that stock may be retired by the payment to the retiring stockholder not only of cash but of other kinds of property. In this case stock was retired with property.

Although the Court of Appeals purports to say that it recognizes that the transfer of the properties for the stock was made for a business purpose, nevertheless, for tax purposes it refuses to recognize that the stock was retired by the transfer of properties. We feel sure that in the minds of many attorneys and in all probability many courts serious questions will now arise as to whether the stock was validly retired or not. For example, let us suppose that petitioner had gone into bankruptcy before

the notes given for the properties had been paid. We can certainly well imagine the argument being made in many courts that actually the Court of Appeals for the Fifth Circuit would in such a case hold that the two transactions even for bankruptcy purposes should be treated as one and that for bankruptcy purposes the stock was retired by notes and the notes should come behind all other creditors. We believe that this does present this important question in the administration of the bankruptcy laws.

## Conclusion

For the foregoing reasons, your petitioner respectfully prays that this petition for writ of certiorari should be granted.[14]

Respectfully submitted,

HOMER L. BRUCE
1600 Esperson Building
Houston 2, Texas
*Attorney for Petitioner*

January 16, 1962.

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[14] In this case the remarks of Justice Douglas in his concurring opinion in C.I.R. v. Lester, 366 U. S. 299, 306-307, seem peculiarly appropriate:

"While I join the opinion of the Court, I add a few words. In an early income tax case, Mr. Justice Holmes said 'Men must turn square corners when they deal with the Government.' Rock Island, A. & L. R. Co. v. United States, 254 U.S. 141, 143. The revenue laws have become so complicated and intricate that I think the Government in moving against the citizen should also turn square corners. * * *

"* * * Resort to litigation, rather than to Congress, for a change in the law is too often the temptation of government which has a longer purse and more endurance than any taxpayer."

## APPENDIX A

IN THE

# United States District Court

SOUTHERN DISTRICT OF TEXAS

HOUSTON DIVISION

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CIVIL ACTION
No. 11,266

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GENERAL GEOPHYSICAL COMPANY,
*Plaintiff*

v.

UNITED STATES OF AMERICA,
*Defendant*

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## FINDINGS OF FACT AND CONCLUSIONS OF LAW

August 5, 1959

This is a suit to recover internal revenue taxes and interest paid thereon alleged to have been erroneously and illegally assessed and collected from plaintiff by defendant.

In this cause plaintiff alleges that on February 25, 1954, it distributed certain of its assets to the Estate of Earle W. Johnson, Deceased, and Mrs. Virginia Johnson in retirement of part of their stock in plaintiff, and that thereafter on February 25, 1954, plaintiff bought those assets from the Estate and Mrs. Johnson for $746,525.00. Plaintiff computed, and reported on its income tax return for 1954,

its income tax liability for 1954 on the basis that its basis for those assets from and after February 25, 1954, was $746,525.00. The Commissioner of Internal Revenue refused to recognize said distribution to, and purchase from, the Estate and Mrs. Johnson and determined plaintiff's income tax liability for 1954 on the basis that plaintiff's basis for said properties was the same as their basis in the hands of plaintiff prior to said alleged distribution on February 25, 1954. The first issue is as to whether or not the Commissioner of Internal Revenue was correct in so holding.

At a pre-trial conference held on January 28, 1959, the Court entered an order that this first issue should be tried first. This cause came on regularly for trial for this first issue before the Court sitting without a jury by consent of the parties, and the plaintiff and defendant appeared by their respective attorneys, and both oral and documentary evidence having been introduced at the trial thereof and the evidence being closed, and the said first issue submitted to the Court for decision, the Court makes the following findings of fact and conclusions of law on said first issue.

## FINDINGS OF FACT

1. This cause arises under the Internal Revenue Code of 1954, and in it plaintiff seeks to recover from the defendant for the year 1954 certain amounts of income taxes and interest paid by it to the defendant and which plaintiff claims were erroneously collected from it by the defendant.

2. The Court finds the facts as admitted by the pleadings and as hereinafter set forth.

3. Earle W. Johnson (herein called Johnson) was a geophysist and founded plaintiff in 1935 to carry on seis-

mograph surveys for oil companies and operators in the search for oil and gas. The plaintiff was very successful due in large part to Johnson's ability and standing in the industry.

4. In August, 1953, Johnson died suddenly. By his will he left his estate in trust for certain beneficiaries with the Second National Bank of Houston as Executor and Trustee. His stock in plaintiff was community property of himself and widow Mrs. Virginia Johnson, and after his death was held one-half by the Bank as Executor and one-half by his widow.

5. At Johnson's death the other officers of plaintiff were Chester Sappington, T. O. Hall and Albert B. Grubb, who had always worked under Johnson's direction. Plaintiff's capital consisted of 1,610 shares of Class A and 4,851 shares of Class B Common Stock, both classes being identical except Class A was non-voting. Among the stockholders were Mrs. Howell A. Johnson, the mother of Johnson, and a long time friend Paul L. Davis. On February 25, 1954, plaintiff's stock was owned as follows:

| *Name* | *Number of Shares* | |
|---|---|---|
| | *Class A* | *Class B* |
| Sappington | 350 | 125 |
| Hall | 350 | 125 |
| Grubb | 20 | |
| Johnson Estate | 200 | 1,530-1/2 |
| Mrs. Virginia Johnson | 200 | 1,530-1/2 |
| Mrs. Howell A. Johnson | | 770 |
| Paul L. Davis | | 770 |
| 12 others | 490 | |
| | 1,610 | 4,851 |

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6. The stock in plaintiff held by the Johnsons represented by far the greater part of their assets. The Bank and Mrs. Johnson realized that neither of them could contribute anything of value in running plaintiff's business and felt that, if plaintiff were liquidated and its properties sold, they would realize far less than the value of their stock in a going concern. The officers of the plaintiff, Sappington, Hall and Grubb felt that they could continue the plaintiff as a successful company but felt that, after the Johnsons had realized the then fair value of the stock, any future earnings should enure to them as officers and the other stockholders. It was realized by all parties that, if the stock of the Johnson Estate and Mrs. Virginia Johnson were retired, the stock of Mrs. Howell A. Johnson and Paul L. Davis should be retired on the same basis. After long negotiations it was agreed between the officers of plaintiff, the Johnson Estate, the two Mrs. Johnsons and Davis that a fair price at which their stock should be retired would be $245 per share which for their 5,001 shares would amount to $1,225,245.00. On July 31, 1953, the Company had an earned surplus of $1,738,944.56 and its surplus on February 25, 1954, was greater than that amount. The attorneys for plaintiff and the Bank advised them that, since the plaintiff had an earned surplus of over $1,225,245.00, the plaintiff could legally retire the 5001 shares by paying the holders the $1,225,245.00 and amending its charter by reducing its authorized capital by the 5,001 shares.

7. As the plaintiff did not have $1,225,245.00 in cash, its officers proposed to the Bank as Executor and the other stockholders that plaintiff would retire their stock by paying part cash and giving them plaintiff's notes for the

balance. However, the attorneys for the Bank advised the Bank and the other three stockholders that, in the light of the decision of the Circuit Court of Appeals for the Fifth Circuit in *Robinson v. Wangemann*, 75 F. 2d 756, and other authorities, if they took notes of the plaintiff in part payment for their stock and plaintiff later failed and went into Bankruptcy while any of the notes were unpaid, all other creditors of the plaintiff, then existing and future creditors, would come ahead of them as holders of the notes. Said attorneys advised the Bank as Executor of the Johnson Estate that it ought not in its fiduciary capacity as Executor to subject the estate to this risk. In the light of this advice the Bank as Executor, the two Mrs. Johnsons and Mr. Davis refused to accept the plaintiff's proposal.

8. Said attorneys of the Bank further advised the Bank as Executor and the other three stockholders that, since the plaintiff had an earned surplus of more than $1,225,-245.00, the plaintiff could legally retire their stock by paying part cash and paying the remainder by transferring to them property of a fair value equal to no more than such remainder if plaintiff would still have an earned surplus. The Bank as Executor and the other three stockholders thereupon proposed to plaintiff that their stock should be retired in that manner, with the Bank as Executor and Mrs. Virginia Johnson accepting part payment in property and part in cash and Mrs. Howell A. Johnson and Davis being paid in cash.

9. The plaintiff and the Bank as Executor and Mrs. Virginia Johnson then agreed upon certain properties to be transferred to them and a list thereof was prepared on which the value of each piece of property was set out as

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agreed upon between the three parties, the total of said values being $746,525.00. The said four stockholders thereupon made a proposal to the plaintiff that they would be willing for plaintiff to retire their 5,001 shares at $245 per share for the following considerations:

| | | |
|---|---|---|
| Johnson Estate and Mrs. Virginia Johnson | | |
| Cash | $101,420.00 | |
| Said property | 746,525.00 | $ 847,945.00 |
| Mrs. Howell A. Johnson - Cash | | 188,650.00 |
| Paul L. Davis - Cash | | 188,650.00 |
| | | $1,225,245.00 |

10. On February 25, 1954, a stockholders meeting of plaintiff was held at which all the stockholders were present in person or by proxy and at that meeting it was unanimously voted to authorize the officers to accept the proposals and to carry them out, to retire the 5,001 shares of stock and to amend the charter of the plaintiff to show the retirement of the 5,001 shares in the authorized capital. The proposals were promptly accepted by the plaintiff, the cash called for in the proposals was paid and the properties covered by the proposal of the Estate and Mrs. Virginia Johnson were conveyed to them, except that at their request the motor vehicles and accessories were conveyed to them in the name of Homer L. Henderson. The certificates for the 5,001 shares were duly surrendered and cancelled and appropriate amendment to the charter was duly filed with the Secretary of State of Colorado, the State in which the plaintiff was incorporated, eliminating the 5,001 shares in the authorized capital of the plaintiff. After those transactions the plaintiff still had a large earned surplus. There-

after neither the Johnson Estate, Mrs. Virginia Johnson, Mrs. Howell A. Johnson nor Paul L. Davis has ever owned any stock in plaintiff.

11. At the time of those transactions there was no agreement of any kind between the plaintiff and the Johnson Estate and Mrs. Virginia Johnson as to said properties, either as to what the latter would do with the properties or in any other way. The latter two owned them absolutely and were perfectly free to do with them as they might desire.

12. Thereafter the Bank as Executor and Mrs. Virginia M. Johnson presented to the plaintiff a proposal as follows:

a. The Estate and Mrs. Virginia Johnson would sell to the plaintiff the properties received by them at certain values, being the same as those at which they had received them.

b. In payment for the properties the plaintiff would execute its note to the Estate for $373,262.50, bearing 5% interest, principal payable in monthly installments of $5,500.00 beginning April 1, 1954, with the balance due on March 1, 1959, and a similar note payable to Mrs. Virginia M. Johnson. The two notes totaled $746,525.00, the agreed price for the properties.

c. The Estate would loan the plaintiff $328,900.00 for which it would execute its two notes to the Estate for $164,450.00 each, bearing 5% interest, principal payable in monthly installments of $2,420.00 beginning April 1, 1954, with the balance due on March 1, 1959.

d. All four notes were to be secured by a deed of trust upon said properties and other properties of the plaintiff.

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13. The plaintiff accepted the proposal, the properties were conveyed to the plaintiff, the Estate made the loan to the plaintiff, and the plaintiff executed and delivered the notes and the deed of trust, all of which occurred on February 25, 1954. All of the notes have been paid in full by the plaintiff, the last payments thereon having been made during the first part of 1959.

14. By said last transaction the plaintiff bought the properties for the total of $746,525.00.

15. The proposal of the Johnson Estate; the two Mrs. Johnsons and Davis to the plaintiff as outlined above as to how their stock should be retired was not originated by the plaintiff. It was originated by the Bank as Executor and the two Mrs. Johnsons and Davis and the latter advised the plaintiff that that was the only manner that was acceptable to those four stockholders for plaintiff to retire the 5,001 shares.

## CONCLUSIONS OF LAW

1. The Court has jurisdiction of the subject matter of, and the parties to this cause.

2. If the plaintiff had retired the stock of the Estate, Mrs. Virginia Johnson, Mrs. Howell A. Johnson and Paul L. Davis by paying them part cash and giving them notes for the balance of the consideration and plaintiff had gone into bankruptcy prior to the payment in full of the notes, all other creditors of the plaintiff would have been preferred in the distribution of the plaintiff's assets over the holders of those notes. *Robinson v. Wangemann*, 75 F. 2d 756. The Bank as Executor of the Estate was acting in a fiduciary capacity and was entirely justified in refusing to accept notes of the Company for any part of the consideration

paid to it in retirement of the stock that it held as Executor and thereby subjecting the Estate to this risk in the event of the bankruptcy of the plaintiff. The Bank as Executor and the other three stockholders in refusing to accept notes of the plaintiff for part of the consideration for the retirement of their stock were actuated by a genuine business purpose so as to avoid this risk that might arise in the bankruptcy of plaintiff.

3. Upon the transfer by plaintiff to the Bank as Executor and Mrs. Virginia Johnson of the properties involved in this cause, the latter two obtained title to those properties free and clear of any claim on the part of plaintiff.

4. The transaction in which the stock of said four stockholders was retired was entirely separate and distinct from the transaction in which the Bank as Executor and Mrs. Virginia Johnson sold the properties involved in this case to the plaintiff for the sum of $746,525.00. The substance of those two transactions was exactly like the form which they took. This Court would not be justified in disregarding the form which these transactions took and, in holding that they should be treated as if said properties had not been conveyed to the Bank as Executor and Mrs. Virginia Johnson and had not been sold by the latter two to the plaintiff and in holding that the transaction should be simply treated as if the plaintiff had retired the stock of these four stockholders by paying them part cash and giving them notes for the balance of the consideration. *Sun Properties, Inc. v. United States*, 220 F. 2d 171.

5. The transaction in which the Bank as Executor and Mrs. Virginia Johnson sold the properties to plaintiff for $746,525.00 was a bona fide transaction and is recognized by the Court as an actual sale by those two parties of

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said properties to the plaintiff.

6. On and after February 25, 1954, plaintiff's basis for said properties involved in this cause for the purpose of computing its income tax liability was $746,525.00, and the Commissioner of Internal Revenue erred in holding that plaintiff's basis for said properties was the same as their basis in the hands of the plaintiff prior to its distribution of them on February 25, 1954, to the Bank as Executor and Mrs. Virginia Johnson.

The clerk will forward copies hereof to the attorneys of record, who will draft and submit judgment accordingly.

/s/ JOE INGRAHAM
Joe Ingraham
United States District Judge

## APPENDIX B
## Original Opinion and Judgment Below
## Court of Appeals Opinion

IN THE

# United States Court of Appeals

FOR THE FIFTH CIRCUIT

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No. 18,530

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UNITED STATES OF AMERICA,
*Appellant*

v.

GENERAL GEOPHYSICAL COMPANY,
*Appellee*

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**Appeal from the United States District Court for the Southern District of Texas.**

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(October 20, 1961)

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Before RIVES and WISDOM, Circuit Judges, and DAWKINS, JR., District Judge.

WISDOM Circuit Judge: February 25, 1954 General Geophysical Company, the taxpayer, transferred certain depreciable assets having a tax basis of $169,290 and a market value of $746,525 to two of its major stockholders in the redemption of their stock. Later that day the taxpayer reacquired the same assets from the former stock-

holders in exchange for corporate notes in the amount of $746,525. In its 1954 income tax return the corporation claimed depreciation deductions using as the cost basis the market value of the assets at the time of the transaction.[1] The sole question this litigation presents is whether the corporation's reacquisition of the assets stepped up the basis. We hold that it did not and reverse the decision below.

Earl W. Johnson founded General Geophysical Company in 1933 to engage in oil exploration and managed its operations until his sudden death in 1953. At his death his estate, his wife, his mother, and a friend Paul L. Davis owned 77% of the corporation's total stock and 94% of its voting shares. The major portion of the remaining shares were owned by Chester Sappington, T. O. Hall, and Albert B. Grubb, who were also officers in the corporation. The Johnson stock was community property: half belonged to the widow and the other half was held by the Second National Bank of Houston as executor and trustee for Johnson's estate. The testimony shows that the bank and Mrs. Johnson soon realized that neither of them could contribute anything of value in running the corporate business, and that they should not attempt. They realized also that if the corporation were liquidated and its properties sold they would receive less than the value of their stock in a going concern. Sappington, Hall, and Grubb believed that they could run the corporation successfully and if so, they should receive its future profits. Accordingly, the corporation agreed to retire the stock held by the bank, the two

[1] In addition to the dispute over depreciation deductions this appeal also affects the taxation of the sale of a small portion of the assets, which produced a taxable gain of $191 according to the taxpayer, $11,049 according to the Government.

Mrs. Johnsons, and Davis. After long negotiations the parties settled on a valuation of the stock at $245 a share, payable partly in cash and partly in notes. The attorney for the retiring stockholders advised against this proposal for fear that it would leave the stockholders without sufficient protection in case the corporation should be forced into bankruptcy. He based this fear on Robinson v. Wangemann, 5 Cir., 1935, 75 F. 2d 756, holding that when a former shareholder holds notes of a bankrupt corporation received in the redemption of his stock, he "cannot be permitted to share with the other unsecured creditors in the distribution of the assets of the bankrupt estate." To avoid exposure to this risk the stockholders proposed that the Johnson stock be retired in exchange for cash and corporate property having a market value equal to that of the stock. The redemption was carried out in accordance with this proposal. A few hours later the corporation repurchased the property for corporate notes, giving the former stockholders a mortgage on certain of its properties.

Witnesses for the taxpayer insisted that there was no agreement between the corporation and the stockholders to re-exchange the corporate properties transferred to the stockholders in the redemption of their shares. The trial judge so found, and it seems clear that there was no legally binding agreement to that effect. The attorney for the stockholders did testify, however, that they had discussed the possibility of such a resale and before February 25, 1954 had prepared the documents for a resale in case that was decided upon after the initial transfer.

Under Section 1012 of the Internal Revenue Code of 1954, "the basis of property shall be the cost of such property." This requires a determination of when the

taxpayer acquired the property and the price he paid for it. Our decision depends on whether or not the transactions in question created an interruption in the ownership of the property, producing a new basis on its reacquisition. The Government asserts that we should disregard the form of the transfer and recognize that the substance of the transactions was a redemption of the corporate stock for cash and notes, leaving the ownership and basis of the depreciable assets undisturbed. The taxpayer answers that there was no fraud or subterfuge in these transactions, that the stockholders acquired complete and unfettered ownership of the properties, and that the trial judge's finding of two separate and independent transactions cannot be overturned on appeal.

The solution of hard tax cases requires something more than the easy generalization that the substance rather than the form of a transaction is determinative of its tax effect, since in numerous situations the form by which a transaction is effected does influence or control its tax consequences. This generalization does, however, reflect the truth that courts will on occasion look beyond the superficial formalities of a transaction to determine the proper tax treatment.

In the landmark case of Gregory v. Helvering, 1935, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596, the Supreme Court refused to give effect to corporate transactions which complied precisely with the formal requirements for nontaxable corporate reorganizations, on the ground that the transactions had served no function other than that of a contrivance to bail out corporate earnings to the sole shareholder at capital gains tax rates. In Commissioner v. Court Holding Co., 1945, 324 U.S. 331, 65 S. Ct. 707,

89 L. Ed. 981, the Supreme Court taxed a corporation on the gain from the sale of an apartment house notwithstanding a transfer of the house to the corporation's two shareholders before the sale, since it found that the transfer was made solely to set in a more favorable tax form a sale which in reality was made by the corporation. Similarly, in Helvering v. Clifford, 1940, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, the Supreme Court taxed a trust grantor on the income of the trust property since the formal transfer of the property by the grantor was lacking in substance. The Court found that the dilution in his control seemed insignificant and immaterial and that "since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position." 309 U.S. at 335-36. See also Estate of Weinert, etc. v. Commissioner of Internal Revenue, 5 Cir., 1961, —F. 2d—; Liston Zander Credit Co. v. U. S. A., 5 Cir., 1960, 276 F. 2d 417; Campbell v. Fasken, 5 Cir., 1959, 267 F. 2d 792; Rupe Investment Corp. v. Commissioner of Internal Revenue, 5 Cir., 1959, 266 F. 2d 624; Georgia-Pacific Corp. v. U. S. A., 5 Cir., 1959, 246 F. 2d 161. Each case must be decided on its own merits by examining the form and substance of the transactions and the purpose of the relevant tax provisions to determine whether recognition of the form of the transaction would defeat the statutory purpose.

The case at bar presents an unusual tax question created by the conjunction of two parts of the tax code not frequently brought together by a single transaction: The provisions governing basis and capital gains, and the rule that no gain is recognized by a corporation when it dis-

tributes property with respect to its stock. The basis of property is determined by its cost; when the property is sold the owner realizes a taxable gain equal to the difference between the basis and the proceeds received in the sale. There is no danger that a taxpayer could effect an artificial sale and repurchase to raise the basis of appreciated property, since such a transaction would subject him to a tax on the step-up in the basis. There are therefore no provisions to prevent tax avoidance by such a device, and the question whether a transfer and reacquisition should be recognized as independent transactions creating tax consequences would generally affect only the *timing* of the imposition of a tax rather than its *amount*. The twist here comes from the fact that the corporation did not incur a tax on the difference between basis and current market value when it transferred the assets to its shareholders in redemption of their stock. Section 311 (a) of the Code provides that "no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of . . . property." This provision is expressly made applicable to stock redemption distributions by the Treasury Regulations.[2] The rule may be easily justified by the fact that when a corporation transfers appreciated property to its shareholders, as a dividend or in exchange for their shares, the gain created by the appreciation has not accrued to the corporation and should not be taxed to it.[3]

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[2] Treas. Reg. 1.311-1 (a) (1955).

[3] If the corporation in effect does realize the gain by handling the sale of the property after its distribution to the shareholders, the gain probably would be attributed to the corporation. See United States v. Lynch, 9 Cir., 1951, 192 F. 2d 718, cert. den'd, 1952, 343 U. S. 934, 72 S. Ct. 770, 96 L. Ed. 1342; Commissioner v.

A new horizon of tax avoidance opportunities would be opened by allowing a stepped-up basis to result from the transaction here effected. Corporations would be enabled without difficulty to raise the basis of their assets whenever it fell below the market value by transferring the assets to shareholders by a dividend or stock redemption and then buying back the same assets for the cash that they otherwise would have distributed directly. Since market values are often pushed up by inflation and the basis is frequently reduced under the liberal depreciation rules far faster than the assets actually depreciate, this possibility would have enormous practical significance. These tax avoidance implications do not constitute a license to courts to distort the laws or to write in new provisions; they do mean that we should guard against giving force to a purported transfer which gives off an unmistakably hollow sound when it is tapped. Under the law, it is of course open to a corporation making a dividend distribution or a stock redemption to distribute appreciated assets rather than cash and to use its cash to purchase similar assets for replacement at a stepped-up basis. Such maneuverings are however obstructed by

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Transport Trading & Terminal Corp., 2 Cir., 1949, 176 F. 2d 570, cert. den. 1950, 338 U.S. 955, 70 S. Ct. 493, 94 L. Ed. 589. These cases were decided before enactment of Section 311, but since that section is largely a codification of the rule laid down by General Utilities & Operating Co. v. Helvering, 1935, 296 U. S. 200, 56 S. Ct. 185, 80 L. Ed. 154 which did precede these cases their validity is probably not undercut by the statute. Mintz and Plumb, Dividends in Kind — The Thunderbolts and the New Look, 10 Tax L. Rev. 41, 45-48 (1954). See generally Raum, Dividends in Kind: Their Tax Aspects, 63 Harv. L. Rev. 590 (1950).

The tax treatment of the corporation making a stock redemption is of course not to be confused with the taxation of the shareholders, a field bursting with difficult problems. See, e.g., Bittker, Federal Income Taxation of Corporations and Shareholders, 208-17 (1959).

their costs. Moreover, in such a case it would be indisputably clear that the corporation had disposed of its former assets and acquired new ones. Where a corporation says that it stepped up the basis by transferring assets to its shareholder and then reacquiring them we must scrutinize the transactions to make sure that the alleged divestiture did occur. The transactions should be recognized as creating an interruption in the ownership of the assets sufficient to produce a new basis *only* when the corporation has made a clear and distinct severance of its owership prior to the reacquisition.

The facts of these transactions will not support a holding that the corporation had terminated its ownership for these purposes. It parted with bare legal title to the property for a few short hours. It made no physical delivery of any of the assets. Its control and use of the property were never interrupted. Even the surrender of its legal title was made under circumstances creating a strong expectation that it would be returned shortly. True, the stockholders may have had complete legal freedom to refuse to resell the assets to the corporation, but there was almost no likelihood that they would do so. It was a foregone conclusion that they would resell them to someone, since the very reason for the original redemption was that they did not wish to continue ownership of the assets and management of the business. And since the assets were already integrated into the operations of the taxpayer and represented 47% of its assets,[4] the taxpayer was the logical purchaser. That the stockholders had already drawn up papers for the resale, in case they decided

[4] The assets transferred were valued by the parties at $746,525. At the rate of $245 per share, that total would represent 3047 shares, or slightly over 47% of the 6461 shares then outstanding.

to make one, undoubtedly strengthened the confidence with which the taxpayer could look forward to the reacquisition of the properties. There was never the whisper of a suggestion that the company was to cut down on its operations, as would be inevitable if it permanently parted with 47% of its assets, including three rigs. The most that can be said is that the taxpayer gave to the bank and Mrs. Johnson the power to divest it of its ownership of certain properties; they held that power for a few hours and then returned it. The transactions, from the corporation's standpoint, were more like an option than a sale, and the option expired quickly without having been exercised.

The taxpayer asserts that the transactions were prompted by a valid business purpose and were effected without a motive of tax avoidance. We accept these assertions, which are supported by the trial judge's findings, as true. They lend support to the taxpayer's case, but they do not control the disposition of the case. Intent often is relevant in questions of taxation, particularly where the bona fides of a transaction is called into question, but in most cases tax treatment depends on what was done, not why it was done. And our decision in this case rests not on the motivation of the transactions in question but rather on our conclusion that the admitted facts of the two transfers preclude a finding of a sufficient hiatus in the corporate ownership of the assets to justify bestowal of a new basis on them after the reacquisition.[5]

[5] If these transactions could not have been explained by valid non-tax reasons, they obviously would have been only a subterfuge which could not have been effective to change the basis of the assets. Thal v. Commissioner, 6 Cir., 1944, 142 F. 2d 874; Seattle Hardware Co. v. Squire, W. D. Wash., 1948, 83 F. Supp. 106, aff'd 9 Cir., 1950, 181 F. 2d 188.

To determine the basis of the assets we look backward to ascertain when the corporation acquired them. We note the transactions here in question, but we can scarcely say that the corporation's ownership dates from that occasion. These transactions, whatever their effect on other legal questions did not create an interruption in the ownership sufficient to produce a new basis. The basis must be found from the original purchase price and the adjustments made to it. The district court's findings may be correct; his conclusions are in error.

The judgment is

REVERSED.

## Court of Appeals Judgment

## JUDGMENT

Extract from the Minutes of October 20, 1961.

UNITED STATES OF AMERICA,
*Appellant,*

versus

GENERAL GEOPHYSICAL COMPANY,
*Appellee.*

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed.

## APPENDIX C

**Opinion and Order on Rehearing Below**
**Opinion on Rehearing**

IN THE

# United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 18530

UNITED STATES OF AMERICA,
*Appellant,*

v.

GENERAL GEOPHYSICAL COMPANY,
*Appellee.*

**Appeal from the United States District Court for the Southern District of Texas.**

## ON PETITION FOR REHEARING

(December 7, 1961)

Before Rives and WISDOM, Circuit Judges, and DAWKINS, District Judge.

PER CURIAM: The petition for rehearing in this case expresses strongly the petitioner's conviction that this Court failed to recognize the bona fides of the transaction. In denying this petition we wish, again, to make clear that we did not base the decision on a lack of good faith in the parties to the transaction. It is true that we said, "we should guard against giving force to a purported transfer which gives off an unmistakably hollow sound when it

is tapped". But this statement was set off (in the same sentence) against the other extreme: "These tax avoidance implications do not constitute a license to courts to distort the laws or to write in new provisions." Throughout the opinion we were careful to say that our decision was not based on any lack of good faith in the parties to the transaction, and that we did not pass on the legal effect of the transaction outside of the tax frame of reference. We do not question the integrity of the parties or suggest that there was any flim-flam. We do not doubt the business purposes of the transaction. The decision does not purport to question the effectiveness of the transaction in protecting the stockholders against the holding in Robinson v. Wangeman, 5 Cir., 1935, 75 F. 2d 756. But we hold and reaffirm that *for tax purposes* there was not a sufficient severance of the corporation's ownership over the assets for the transaction to create the tax consequence that when the corporation reacquired the assets it took them with a stepped-up basis. The transaction is analogous to a Clifford trust, valid under state law but ineffective *for tax purposes* to remove the trust income from the settlor's taxable income. Helvering v. Clifford, 1940, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788. It is ORDERED that the petition for rehearing filed in the above styled and numbered cause be, and the same is hereby

DENIED.

## ORDER DENYING REHEARING

Extract from the Minutes of December 7, 1961

UNITED STATES OF AMERICA:

No. 18530 versus

GENERAL GEOPHYSICAL COMPANY

It is ordered by the Court that the petition for rehearing filed in this cause be, and the same is hereby, denied.

## APPENDIX D

**United States of America, Appellant v. McNair Realty Company, Appellee.**

U. S. Court of Appeals, 9th Circuit, No. 17,334, 12/13/61. Affirming District Court, 60-2 USTC ¶ 9772, 188 Fed. Supp. 451.

[1939 Code Sec. 22(a)—similar to 1954 Code Sec. 61(a); 1939 Code Sec. 115(c)—similar to 1954 Code Secs. 302(a) and 331(a); covered in 1954 Code Sec. 346 (a)]

**Who is the taxpayer: Corporation v. Stockholder: Sale of property after distribution in partial liquidation.**—A closely held corporation transferred to one of its stockholders a 64% interest in a building in full liquidation of the shareholder's stock. When the property was sold by a deed recorded on the same day as the deed to the retiring shareholder, the corporate taxpayer was held to be taxable only on the gain on its 36 percent interest in the property, and not on the entire gain. The primary purpose of the transaction was to permit the one stockholder to withdraw; thus, it was not a sale by the corporation for the purpose of winding up its affairs. Back references: ¶ 304.66 and 2496.202.

[1939 Code Sec. 117(a)—similar to 1954 Code Sec. 1221]

Capital gains: Sale of investment property.—A real estate investment company realized capital gain on the sale of improved real estate which it had held as an investment. Back reference: ¶ 4729.705.

Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson, Melva M. Graney, Kenneth E. Levin, Department of Justice, Washington 25, D. C., Moody Brickett, United States Attorney, Butte, Mont., for appellant. H. Cleveland Hall, John C. Hall, Strain Bldg., Great Falls, Mont., for appellee.

Before CHAMBERS, ORR and BROWNING, Circuit Judges.

PER CURIAM: Certain real property originally belonging to the appellee corporation was sold. In form the transaction involved the transfer of a partial interest in the property to one of the corporate stockholders in complete liquidation of that stockholder's interest in the corporation, followed by a sale to a third party of their respective interests in the property by the stockholder and the corporation. If the transaction was in fact what it purported to be the appellee corporation was subject to tax only on the capital gain resulting from the sale of its partial interest in the property. *United States v. Cumberland Public Service Co.* [50-1 USTC ¶ 9129], 338 U.S. 451 (1950). If, on the other hand, the sale was in reality a sale by the corporation and the distribution to the stockholder merely a sham, utilizing the stockholder as a conduit through which to pass title from the corporation to the purchaser, the corporation was subject to tax on the capital gains realized from the sale of the whole property. *Commissioner v. Court Holding Co.* [45-1 USTC ¶ 9215], 324 U.S. 331 (1945).

Taken together, the decisions in *Commissioner v. Court Holding Co.*, and *United States v. Cumberland Public Service Co.* make it clear that, in this area, the task of apply-

ing the statutory criteria to the multitude of particular situations that inevitably arise is to be left to the District Court and the Tax Court, as the case may be, and their conclusions are reviewable only for clear error. As the Supreme Court stated in *Cumberland Public Service Co.*, "It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs." [50-1 USTC ¶ 9129], 338 U.S. at 456.

In the present case the District Court [60-2 USTC ¶ 9772] concluded that the partial distribution of the property to the stockholder in liquidation of his interest in the corporation preceded the sale and "was not a sham," and that the subsequent sale of the stockholder's interest in the property to the third party purchaser "constituted a sale by him and not by" the corporation. Since this conclusion is not clearly erroneous, it would be inappropriate for us to inquire whether we might have reached a different one based upon differing inferences from the facts. "It was for the trial court to draw inferences and determine what the evidence means." *Haggard v. Wood*, —F. 2d— (9th Cir., 1961) No. 17,284, decided Nov. 20, 1961; *Rollingwood Corp. v. Commissioner* [61-2 USTC ¶ 9574], 190 F. 2d 263, 265 (9th Cir. 1951).

We therefore affirm.